R5C50-2

JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

NO. 14A

April 12, 1991

JAPAN'S TRADE INSURANCE PROGRAM: RESPONDING TO THE THIRD WORLD DEBT CRISIS

Summary

Trade and investment insurance plays an important role in promoting business activities, particularly in developing countries where commercial and political risks are high. The worldwide debt crisis that began deepening in the early 1980s resulted in a rapid increase in the number of insurance claims as indebted countries failed to keep up with payments on their trade bills or halted investment projects. The ministry responsible for such insurance in Japan, the Ministry of International Trade and Industry, initially reacted passively to the financial crunch caused by the greater number of claims; it increased insurance premiums and suspended new contracts in an effort to keep the insurance fund self-sustaining.

Before long, however, MITI realized that a more active approach was necessary to address trade and investment opportunities in the face of the debt crisis. Responding to urgent requests from officials in recipient countries as well as Japan's private sector, MITI redefined trade insurance as an important tool for extending economic cooperation to indebted countries. As a result, the Japanese government increased its direct financial support for the program, offsetting a large portion of the deficit in MITI's trade insurance account; it permitted the fund both to borrow from government trust accounts and to tap into the general account budget.

This more active and flexible policy generally has been welcomed by both beneficiaries and private Japanese creditors. Within Japan, however, there have been calls to improve the transparency of the premium-setting process to help minimize the adverse effects of the monopoly exercised by the government over trade insurance.

Why Trade Insurance?

As businesses expand their trade and investment activities around the world, they encounter risks that may not be present at home. Among the contingencies addressed by government-operated trade insurance programs are such postshipment problems as the failure to collect payment on exported goods or dishonored letters of credit as well as an inability to recover prepayments for foreign-supplied products not shipped. Sometimes the insurance is required if an exporter is helping the buyer to arrange financing. Investors covered by government-run insurance programs get protection against confiscation, bankruptcy and various political events.

Both trade and investment insurance basically cover commercial and political risks. A business partner's violation of a contract could have greater ramifications in foreign countries than at home, where legal or other recourses are better understood. In overseas transactions business hazards can range from poor information about the creditworthiness of buyers to changing regulatory measures and currency revaluations. These commercial risks are especially prevalent in developing countries.

Special problems for exporters and foreign investors lie in noncommercial or political risks brought about by events not linked to either party in a deal. These events include war, revolution, insurrection, civil strife and natural disasters as well as such government actions as expropriation of private property and unanticipated imposition of export and import controls, including suspension of remittances. Apart from these political contingencies, economic problems also sometimes force governments to suspend normal business activities.

Business dealings in Third World countries often are accompanied by commercial or political risks. Direct investments, particularly long-term projects, carry the most hazard. After the run-up in oil prices in the early 1970s, for example, many resource-rich countries like Mexico, Iran and Nigeria launched big, long-term projects, such as mining development and the construction of manufacturing complexes. In addition to the export of equipment some contracts involved construction and operation of the project, a factor that prolonged completion of the contract. Because of the lengthy nature and the large size of these projects as well as the often great technical difficulties encountered, the costs involved were substantial; so were the risks. Businessmen in charge of projects like these in developing countries have long seen the need for protection against political and commercial risks to reduce the chances of losses.

The JEI REPORT (ISSN 0744-6489) is published weekly except for the New Year, Memorial Day, Labor Day, Thanksgiving and Christmas holiday weeks for $40 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Second class postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI REPORT, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036.

What is Trade Insurance?

While exporters often obtain coverage of their goods in transit through shippers' insurance contracts or counteract currency fluctuations through options on the exchange markets, protection against commercial and political risks is not available from private insurers in Japan and Europe and is offered by only a few carriers in the United States. Since trade and investment insurance is seen as an important economic policy tool, it is handled in most industrialized countries by the government or a government-backed organization.

The Export Insurance Division of the Ministry of International Trade and Industry's International Trade Administration Bureau has operated both trade and investment insurance programs since 1950, which was 16 years after the United States created its program in the Export-Import Bank. Trade and investment insurance in the United Kingdom has been managed since 1919 by the Export Credits Guarantee Department under the auspices of the Department of Trade and Industry. France established an independent insurance company, Compagnie Francaise d'Assurance pour le Commerce Exterieur, in 1946 to deal with trade and investment insurance. Germany set up Hermes in 1917 to handle trade insurance and Treurbert in 1925 for investment insurance. The early start of a trade insurance system in Europe enabled European governments to use trade insurance to promote their countries' business overseas. The Japanese government modeled its trade insurance system on Great Britain's operation.

Governments generally have accepted involvement in the trade and investment insurance business for various reasons. Insurance claims caused by political risks in many cases are related to government actions. Moreover, governments often intervene to help reschedule debt payments. Shipments, too, sometimes are affected by government actions -- for example, if a government imposes economic sanctions on a certain country. The private sector turns to the government as a natural recourse for compensation of business losses associated with a government's actions. Less directly, insurance claims caused by political risks sometimes amount to such a large sum that no single private insurer could afford to pay off. In addition, government-supported insurance often has been provided at a subsidized price,[1] thereby assisting the domestic export sector in international competition.

MITI's Insurance Operation - Japanese exporters or investors that want to reduce the risks related to their overseas activities apply for insurance from MITI's trade insurance office. An applicant pays a certain portion of the value of its export or investment as the insurance premium. The portion, or premium rate, is conditioned by the period of the contract as well as the destination of the export or the location of the investment. The longer the contract period, the higher the premium. Additionally, MITI assesses the political risk of a recipient country and ranks it on an eight-notched scale of 0.5 to 5, the latter being the highest risk. Premium rates for highly indebted countries like Brazil, Nigeria and Poland, for example, are 10 times higher than those for the United States or Canada.

[1]Donald Putnam Henry, The Financial Cost of Export Credit Guarantee Programs (Santa Monica, California: Rand Corp., 1987), p. 17.

Like other countries' trade and investment insurance systems, MITI's insurance account is managed on a self-sustaining basis. In principle, revenues from premiums and refunds should finance the payment of insurance claims. Since insurance covering only applicants doing business with high-risk countries would require incredibly expensive premiums, many exporters and investors join together on a comprehensive group policy to obtain the lowest rates. MITI has concluded agreements with 14 exporters' associations, such as the Japan Textile Products Exporters' Association and the Japan Machinery Exporters' Association, to cover every type of export deal by the groups' member companies regardless of destination. MITI offers discounted premiums to these firms. In turn, member companies are obligated to pay premiums based on all their export transactions, including low-risk shipments to the United States and Western Europe. In other words, in cases of comprehensive group coverage high-risk transactions are cross-subsidized by premiums paid on transactions with lower-risk countries. Because of comprehensive group coverage, MITI can afford to offer less expensive premiums for high-risk projects than otherwise would be possible. However, exporters to relatively riskless countries pay higher premiums than the degree of risk would dictate. Some analysts say this tends to blunt business evaluations of risk and to lead to higher exposure to loss. In addition, because of the group nature of the insurance, a higher percentage of the nation's exports is covered by insurance than under a system that puts more burden on the individual exporter.

When claims for losses are filed, the insurance agency's indemnity varies according to the type of insurance and whether coverage was for commercial risk, for which payments might range from 40 percent to 80 percent of actual losses, or political risk, where payments are a maximum of about 95 percent of actual losses. Proportional compensation is typical for most insurance coverage. Once a claim is paid, the agency either suspends writing new policies on transactions with the country concerned or raises premiums until the problems causing insurance claims for that country are solved. If a claimant successfully recovers its losses through the resale of insured products to other customers or eventual payment from the initial customer, it has to refund the equivalent recovered sum to the insurance agency.

The American Case - In the United States some private insurers, along with public-sector insurance bodies, offer trade and investment insurance. The Export-Import Bank runs the government's trade insurance program, but only a limited number of U.S. exporters apply for Eximbank export insurance. The total value of officially insured contracts is barely 4.4 percent of all U.S. exports; internationally the figure runs at more than 20 percent for French exports and 30 percent-plus for Japanese and British exports. The Overseas Private Investment Corp. insures against the risks involved in overseas investments, but coverage is limited to small companies; eligibility is restricted to manufacturing and mining companies with annual sales of less than $142 million or nonindustrial companies with stockholders' equity of less than $48 million.

The availability of private trade and investment insurance sets the United States apart from Japan and Europe. According to a survey by Rand Corp., private insurance companies write roughly one-third of the political risk insurance business in the United States.[2] Premiums vary on a firm-by-firm basis

[2]Daniel F. Kohler, Stephen W. Salant, Donald P. Henry, Keith W. Crane, Mark M. Hopkins, Economic Cost and Benefits of Subsidizing Western Credits to the East (Santa Monica, California: Rand Corp., 1984), p. 17.

and take into account the risks associated with a project or deal, the types of risks an applicant wants to cover and how much coverage the applicant wants per incident. Compared with MITI's group insurance policy, which generally covers all kinds of commercial and political risks, American insurers would charge considerably higher premiums to provide applicants the same universal coverage that MITI offers. However, U.S. exporters or investors can choose exactly what risks they want to cover. If an applicant wants only a guarantee against currency inconvertibility and is not interested in insurance against losses stemming from political violence, it can pay a lower premium than would be required for universal coverage. Moreover, a manufacturer does not have to pay premiums for insurance on exports to low-risk countries in exchange for getting a lower rate for insurance covering riskier areas.

Debt Crisis and Trade Insurance

Since the early 1980s developing economies have suffered serious damage from their accumulated debts. The strain from the worldwide debt crisis has dampened the business environment in Third World countries. An associated breach of payments from debt-laden concerns and countries resulted in an expansion of insurance claims at an unprecedented pace. To deal with the situation MITI undertook a fundamental review of its trade insurance policy.

Table 1 illustrates the debt situation in developing countries. Overborrowing by developing countries became a recognized problem when Mexico failed to make payments on its debt in 1982. Before long other Latin American debtor nations, such as Brazil and Argentina, followed suit. Suspension of repayment schedules also became more common among African and Eastern European borrowers. At the end of 1989 developing countries owed nearly $1.2 trillion -- the equivalent of 44.1 percent of the Third World's gross national product. Although the ratio of loan repayments to the total export earnings of developing countries dropped from 32.5 percent in 1986 to 27.5 percent in 1989, the figure still exceeded the 26.3 percent of 1983 when the debt crisis began to spread among developing countries. The capital outflow from developing countries has exceeded the inflow every year since 1983 (see Table 2). Industrial-country lenders generally have been reluctant to extend new credit to countries that are still saddled with large principal and interest payments.

One step taken by indebted countries to alleviate this credit crunch was to ask creditor governments and multilateral financial institutions to work out extended repayment schedules. Although rescheduling did not solve the fundamental problems disrupting the developing nations' economies, creditor governments generally agreed to new repayment plans and instituted programs to help provide credit flows. The total amount of officially rescheduled payments, including foreign aid loans, loans provided by public financial organizations and private credits covered by trade insurance, reached $130 billion at the end of 1989. Of the rescheduled debt, the Japanese government and private creditors were owed $11 billion, approximately 8.5 percent of the total. More precisely, official development assistance, or yen loans, comprised $1 billion, loans by the Export-Import Bank of Japan amounted to $2 billion and privately extended credit covered by trade insurance totaled $8 billion.

As soon as the Japanese government accepted a rescheduling arrangement with a country, private creditors rushed to MITI to seek compensation for the delayed payments. Since MITI agreed almost automatically to pay claims caused

Table 1: Debt Situation in Developing Countries, 1980-89

(in billions of dollars)

	1980	1983	1984	1985	1986	1987	1988	1989
Total Cumulative Debt	$573	$819	$855	$952	$1,047	$1,176	$1,156	$1,165
Long-Term Debt	428	644	684	780	882	999	980	995
From Public Sources	158	221	234	296	360	440	443	467
From Private Sources	270	423	450	484	522	559	537	528
Short-Term Debt	132	141	134	132	122	135	141	139
IMF Credits	13	34	36	40	43	43	35	32
Debt Service Ratio	21.4%	26.3%	26.1%	30.4%	32.5%	29.0%	28.5%	27.5%
Debt/GNP Ratio	27.8%	40.5%	41.8%	45.6%	48.9%	50.5%	43.9%	44.1%

Source: World Bank

Table 2: Capital Flows from Developed Countries to Developing Countries, 1982-89

(in billions of dollars)

	1982	1983	1984	1985	1986	1987	1988	1989
Borrowing by Developing Countries	$124	$108	$97	$100	$103	$107	$108	$111
Repayment of Principal	49	46	50	67	76	83	88	86
Repayment of Interest	68	65	69	70	65	64	72	77
Total Capital Flow to Developing Countries	6	-2	-22	-36	-38	-40	-52	-52

Source: World Bank

by the new payment arrangements, the balance in the government's insurance account shrank rapidly. The fund actually has been in deficit since FY 1982, a function of increased payments of insurance claims. Between FY 1980 and FY 1989 MITI paid out close to Y1.1 trillion ($8.1 billion at Y135=$1.00) in claims. Of this sum payments caused by rescheduling arrangements amounted to Y905.8 billion ($6.7 billion), or 83 percent of the total. Although part of the total rescheduled debt already has been repaid by debtor countries, MITI still is awaiting repayment of more than Y800 billion ($5.9 billion) (see Table 3).

Other nations' trade insurance agencies have suffered the same problems as MITI. According to the Bern Union, which consists of the major industrialized countries' official insurance bodies, government-operated insurance organizations in the leading developed nations recorded a large volume of red ink in 1989 (see Table 4). This country's Eximbank had the smallest deficit, adding up to only 0.83 billion Swiss francs ($530 million at 1989's average exchange rate of Sf1.546=$1.00). This distinction underscores the fact that Eximbank's trade insurance program is tapped by a limited number of U.S. exporters. European governments' insurance organizations, however, all recorded much larger deficits than did MITI.

MITI's Response to Debt Crisis

Restriction of Underwriting - MITI's initial reaction after the Mexican debt crisis was rather passive. As insurance claims for existing export contracts with Mexico began flooding into MITI, payments from the trade insurance account began exceeding revenues for the first time since its creation in 1950. Since the fund had a Y145 billion-plus ($1.1 billion) surplus that had built up through FY 1981, MITI could pay the claims using this reserve. But since this money was expected to run out in a few years, MITI officials began looking for a way to balance the insurance account in the short run.

Immediately after paying off the first Mexican insurance claim, MITI stopped writing new export insurance contracts for Mexico as well as many other indebted countries as a preventative measure to avoid an increase in claims. The ministry also restricted the total value of contracts that it would cover and introduced higher premiums for business with Latin American, African and Eastern European countries where the economic situation was judged as possibly getting worse. By the mid-1980s MITI had closed the door on trade insurance or restricted its availability for more than 50 countries.

Fewer Exports to Developing Countries - Both Japan's private sector and the governments of debtor nations complained about MITI's cautious handling of the trade insurance crisis. With Japanese exporters increasingly unable to obtain trade insurance, shipments to highly indebted countries shrank. International Monetary Fund figures indicate that worldwide exports to the 15 most indebted countries dropped from $133 billion in 1981 to $80 billion in 1984. Most big development projects in these countries were suspended or delayed as exporters and investors became less willing to ship equipment or provide financing. Japan's exports of plant and equipment to Third World countries contracted by nearly two-thirds in the 1981-84 period, tumbling from $13.7 billion to $4.8 billion. New debt repayment schedules often did little to reverse this decline because Japan, Europe and the United States continued to restrict trade insurance. Developing countries, therefore, lobbied for increased availability

Table 3: Japan's Trade Insurance Account, FY 1980-FY 1989

(in billions of yen)

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989
Payment of Claims	Y22.1	Y37.6	Y62.7	Y80.5	Y141.5	Y164.3	Y169.0	Y109.5	Y164.8	Y142.7
Payment Due to Rescheduling	8.0	25.3	43.6	51.5	98.8	146.0	161.2	93.4	142.6	135.4
Account Balance	13.4	0.7	-12.7	-31.0	-74.4	-78.5	-82.0	-44.2	-103.5	-39.2
Cumulative Net Rescheduling Claims	28.4	53.7	97.3	148.8	247.6	393.6	437.8	507.3	677.9	818.8
Cumulative Net Borrowing from Fiscal Investment and Loan Program	0.0	0.0	0.0	0.0	0.0	74.0	164.1	219.5	284.8	294.1
Cumulative Government Funding from General Account Budget	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	97.0	100.2

Source: Ministry of International Trade and Industry

Table 4: Major Industrialized Countries' Trade Insurance Account, Cumulative 1982-89

(in billions of Swiss francs*)

	Total Receipts	Total Payments	1989 Yearend Balance
Japan (EID/MITI)	Sf4.79	Sf10.48	Sf-5.69
France (COFACE)	17.55	24.89	-7.34
Great Britain (ECGD)	8.91	17.22	-8.31
West Germany (HERMES)	5.52	12.33	-6.81
United States (Eximbank)	1.06	1.89	-0.83

*Swiss franc 1.5465=$1.00 at 1989's average exchange rate.

Source: Bern Union

of trade insurance and the extension of new credits to help them recover from their economic straits.

MITI's tough line on new trade insurance meant the private sector was likely to forgo business opportunities in developing countries where the risks of default were high. To make matters worse manufacturers that had group policies still had to pay the same insurance premiums even though their exports generally were headed to low-risk countries, such as the United States. This increased the frustration of group policyholders since they saw little merit in paying premiums for low-risk exports unless the government extended insurance coverage to riskier shipments to highly indebted countries.

Finding an Alternative Funding Mechanism - As the debt crisis deepened MITI's trade insurance account deteriorated (see Table 3). Payments attributable to rescheduling arrangements totaled Y98.8 billion ($731.9 million) in FY 1984, nearly double the previous year's payouts. Furthermore, premium income had decreased in line with the ministry's new restrictions on writing insurance. The trade insurance account's self-sustaining nature therefore was jeopardized. By FY 1985 the reserves built up through the 1970s were exhausted. Facing a funding shortfall, MITI asked the Ministry of Finance to allow it to borrow money from the trust funds used to finance the Fiscal Investment and Loan Program, the government's capital budget.

To justify this unprecedented request MITI reviewed its handling of insurance claims related to the debt crisis. Since the claims were in response to debt-rescheduling arrangements, MITI reasoned that once developing countries repaid their loans, the money paid out in trade insurance claims would be refunded and the ministry then could repay the trust funds. Thus, while the trade insurance account would remain in the red for some years, it would be balanced over the long run -- provided that indebted countries eventually paid off their loans. This provided MITI with the rationale to tap the trust funds. Between FY 1985 and FY 1989 the ministry borrowed a total of Y294.1 billion ($2.2 billion).

Relaxation of Underwriting Guidelines - Responding to the requests from developing countries as well as Japan's private sector for a more liberal trade insurance-writing policy, MITI relaxed its restrictions on export coverage for several Third World nations. Not only did this relaxation benefit selected countries as well as Japanese companies doing business there, but it also contributed to an increase in the insurance account's receipts. To many analysts MITI's revised policy represented an acceptable compromise between its fiduciary responsibilities and the demands of Third World countries and Japanese exporters.

New Problems and New Thinking

Introduction of New Debt-Relief Measures - While the rescheduling of loan repayments brought short-term relief to struggling developing countries, the fundamental economic causes of their financial problems had not been addressed. Still seeing little basic reform by the end of the 1980s, lending nations and international financial institutions like the World Bank and the IMF reluctantly concluded that drastic debt-relief measures were unavoidable, including cancellation of part of some countries' cumulative debt (see JEI Report No. 7A, February 22, 1991). Following a 1988 accord among the seven leading industrialized economies at their summit meeting in Toronto, Japan promised to write off a portion of the outstanding debt owed by 18 countries with low national incomes, particularly in sub-Saharan Africa. Credit from private sources covered by trade insurance was included in the debt eligible for cancellation, as were ODA loans.

Highly indebted middle-income countries, such as Mexico, Venezuela and the Philippines, qualified for a new debt-relief strategy initiated by Treasury Secretary Nicholas Brady in March 1989. The Brady Plan's goal is to reduce the burden of long-term loans from private-sector financial institutions (see JEI Report No. 6B, February 9, 1990). Moreover, negotiations on a large-scale reduction of Poland's debt, including bank loans covered by trade insurance, have begun. Poland owes Japan an estimated Y190 billion ($1.4 billion).

While the Brady Plan and similar debt-relief measures help struggling developing countries, these steps cause problems for Japan's trade insurance program since debt cancellation means the loss of money. By extension, part of the current deficit in the account never will be wiped out since countries like Mexico and the Philippines no longer are obliged to repay some loans against which trade insurance was written. Thus, MITI's rationale for borrowing from government trust funds to tide over the trade insurance account has been undercut to some extent.

Impact of Persian Gulf Crisis - The Persian Gulf crisis that began last August when Iraq invaded Kuwait generated an increase in insurance claims on trade with both Iraq and Kuwait as well as with frontline states like Egypt and Turkey that were hard hit by the international trade embargo against Baghdad. At the time that Tokyo froze all business transactions with Iraq and Kuwait private financial institutions in Japan had Y430 billion ($3.2 billion) in loans outstanding to Iraq and Y80 billion ($592.6 million) outstanding to Kuwait. Roughly Y218 billion ($1.6 billion) of Iraq's loans and Y40 billion ($296.3 million) of Kuwait's came due during FY 1990. Under the terms of trade insurance contracts MITI had to compensate lenders for the nonpayments. Moreover, while the full extent of damage to Japanese-owned facilities in Kuwait

and Iraq remains to be seen, some Japanese investors are expected to withdraw from ventures in these two countries and probably will file claims for compensation based on their investment insurance.

Claims for Investment Insurance - Unlike export insurance claims, few investment insurance claims have been filed -- in part because Japanese direct investment in developing countries was limited until the early 1980s but also because political incidents like expropriation or war have been rare over the past decade. If, however, political events cause Japanese investors to file claims, the amounts involved are likely to be huge. For its part MITI has little expectation that the money it pays out to investors will be recovered from the offending country's government.

The dissolution of the Iran-Japan Petrochemical Corp. is a good example. Insurance claims filed in connection with this project, a joint venture between the Iranian government and a Japanese consortium consisting of the Mitsui Group's five main companies and the Overseas Economic Cooperation Fund, have reached Y93 billion ($688.9 million) -- the largest amount ever filed with MITI by a single contractor. Launched 19 years ago, the IJPC project was affected by a series of political events in Iran. Work on the Bandar Khomeini petrochemical complex was suspended during the 1979 revolution, although 85 percent of the facility had been built. The two sides later agreed to resume construction, but the outbreak of the Iran-Iraq War resulted in several critical parts of the facility being destroyed from Iraqi bombing (see JEI Report No. 36B, September 22, 1989). In 1989 the two parties finally agreed to dissolve the joint venture into which the Japanese side alone had invested over Y300 billion ($2.2 billion). Whether MITI will pay all the insurance claims remains unclear. What is more certain is that MITI will have to find revenue sources other than loans from government trust funds to offset the cost of unrecovered payments.

MITI's Response to Prospective Account Shortfalls - Facing expected increases in unrecovered insurance expenses, MITI has begun to take another look at its trade and investment insurance program. The ministry's major concern is who should be asked to cover the large deficit looming in the insurance account, Japanese businesses or taxpayers? In FY 1989 MITI pressed both the private sector and the Ministry of Finance for help with the shortfall.

After consultations with the business community MITI boosted insurance premiums approximately 40 percent on average starting in FY 1989. MITI also maneuvered manufacturers of electronics goods and motor vehicles into joining group insurance programs. Although these products rank as Japan's top exports, electronics and automotive makers had used trade insurance only rarely, mainly because a majority of their overseas shipments go to the United States, Europe and Southeast Asia. For these companies the premiums for trade insurance are equivalent to export surcharges. The automotive and electronics industries eventually bowed to MITI pressure, mainly because they were trying at that time to expand markets outside the United States and Europe.

As a result of the 40 percent premium hike and the larger number of exporters participating in group insurance plans, premium income jumped 60.6 percent in FY 1989 (see Table 5). The value of insured contracts also climbed, going from almost Y8.7 trillion ($64.1 billion) in FY 1988 to Y18.3 trillion ($135.5 billion) during the April 1989-March 1990 time frame. Over the same period Japan's total exports increased a modest 11.1 percent to Y38.9 trillion

Table 5: Japan's Trade Insurance Account, FY 1988-FY 1989

(in billions of yen)

	FY 1988	FY 1989	Percent Change
Value of Insured Contracts	Y8,647.4	Y18,295.2	111.6%
Premiums	21.3	34.2	60.6
Refunds of Rescheduled Credits	40.0	69.2	73.0
Payments for Insurance Claims	164.8	142.7	-13.4
Balance	-103.5	-39.3	

Source: Ministry of International Trade and Industry

($288 billion). Since the value of insured contracts includes long-term exports as well as foreign direct investment, it is difficult to figure out what portion of Japan's FY 1989 exports were insured. Nevertheless, the beginnings of a drastic expansion in insured contracts are clear, and that development contributed to higher premium income.

While pressing exporters to shoulder more of the cost of the trade insurance system, MITI also lobbied the Finance Ministry for funding from the general account budget. Between 1950 and 1988 the government's initial Y6 billion capitalization of the trade insurance program had been increased by only Y1 billion. Compared to the trade insurance agencies of other countries, such as the Eximbank with its $1 billion in government-supplied capital, the Y7 billion ($51.9 million) capitalization of the Japanese program was small. The value of insured export contracts was more than 10 times higher than Eximbank's, yet the MITI-run insurance system had only one-twentieth of its counterpart's capital. As long as Japanese exports grew at a rapid rate annual premium income covered current losses, even though projected risks were underfunded on a long-term accrual basis. When payouts finally caught up with receipts not only were higher premium rates necessary, but a beefed-up capital structure was required as well.

In 1988 MITI asked the Ministry of Finance to earmark money in the general account budget to increase the capitalization of the trade insurance system to at least Eximbank's level. Getting financing from the general account budget would mean that taxpayers ultimately covered insurance claims paid to the private sector, but MITI officials reasoned that trade and investment insurance not only benefits the business community but also enhances Japan's economic cooperation with the developing world.

Although initially designed to reduce risks for Japanese exporters and overseas investors, the trade and investment insurance program became recognized as an important tool for facilitating help to developing economies via private-sector activities. Most developing countries have asked for assistance from Japan's business community as well as the government's foreign aid program in the belief that private-sector involvement will contribute directly to strengthened export competitiveness. Trade insurance has been assigned the role

of encouraging the private sector's activities in the developing world, especially if otherwise there is a chance that companies would hesitate to provide loans or invest there.

Based on this justification, the government decided to expand the trade insurance system's capital by drawing on the general account budget. The FY 1988 supplemental budget provided a Y90 billion ($666.7 million) infusion. Another Y3.2 billion ($23.7 million) was included in the initial FY 1989 budget. Of this, Y1.7 billion ($12.6 million) was considered foreign aid since it compensated for the cancellation by Japanese commercial creditors of low-income countries' debt. The initial FY 1990 budget contained Y3.7 billion ($27 million) more money, of which Y2.15 billion ($15.9 million) was counted as ODA; an additional Y40 billion ($296.3 million) was approved as part of that year's supplemental budget process. Funding in the current fiscal year's initial budget jumped to Y8.5 billion ($63 million), including nearly Y2.6 billion ($18.9 million) classified as foreign aid. As of April 1991 MITI's trade and investment insurance account had a Y152.3 billion ($1.1 billion) reserve -- an amount equivalent to Eximbank's capital.

More Flexible Operation - Trade insurance can play an important role in helping the economies of indebted countries recover by promoting capital inflows from the private sector, but MITI's earlier scheme generated only broad incentives to export to or invest in countries with above-average risk assessments. Recently the ministry has begun using trade insurance as a tool to promote economic relations with particular developing countries. Instead of suspending trade insurance for highly indebted countries like Brazil and Poland, MITI policymakers have indicated a willingness to approve certain types of export or investment insurance contracts for these borrowers -- provided officials are convinced that the insured transaction will accelerate economic recovery in the recipient countries. MITI also extended trade insurance to Turkey and Egypt during the Persian Gulf hostilities in line with Japan's economic support for frontline states, even though political and commercial risks increased tremendously.

As part of its new case-by-case approach to providing insurance, MITI has begun to require applicants to pay surcharges for contracts involving countries where insurance previously has been suspended. Although premium rates typically are defined by regulation, there is no public reference table for the surcharges since they are worked out between the ministry and individual applicants. Some experts estimate that the extra payments often are two or three times greater than the highest premium rate applicable to normal insurance contracts.

Given MITI's monopoly on trade insurance in Japan, exporters have the choice of paying the surcharges set by the ministry or abandoning the transactions they wanted to insure. Japanese companies interested in investing in high-risk countries do have an alternative source of insurance, the Multilateral Investment Guarantee Agency, which is a World Bank affiliate. To avoid end runs of its national monopoly, however, MITI asks Japanese businesses to consult it before applying to MIGA.

Despite the drawbacks for both deeply indebted Third World countries and Japan's business community of MITI's current approach toward trade and investment insurance, ministry officials believe their case-by-case strategy is

preferable to a blanket suspension of insurance coverage for high-risk nations. Analysts argue, however, that a more transparent system would minimize any harmful effects of MITI's monopoly. They add that greater transparency is all the more necessary because of the substantial amount of taxpayer money that has been funneled into the trade insurance account in recent years to cover the fund's red ink.

Participation by Private Insurers - Some experts have suggested that a dose of competition would improve the situation. Until recently private insurance companies would have been hard-pressed to compete with the MITI-run trade and investment insurance system with its pooled rate structure. MITI's current case-by-case approach to providing coverage on transactions with high-risk countries, however, is similar to how American insurance firms write trade and investment insurance. That raises the possibility that private insurers could compete successfully with the government's program. To date, though, no insurance company has indicated any interest in going into the trade insurance business in Japan. In any case the Finance Ministry would have to sanction such an operation, since it regulates the insurance industry. MOF, which is involved in multilateral debt-relief arrangements for Third World countries as well as in MIGA's activities as the Japanese government's representative, has become more interested in trade and investment insurance, especially since MITI began asking for government funding of its program. That could set the stage for another review of the basic policies and the operation of the government's trade and investment insurance system. Such a study no doubt would explore the possibility of allowing private carriers to write trade and investment insurance.

For further information, contact Tadashi Saito.

* * * * * *

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

NOTE

ONLY THE FOLLOWING PAGES OF THIS

PUBLICATION HAVE BEEN FILMED

Entire Issue